

NATURAL GAS SUPPLY ASSOCIATION



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Building 85
Denver Federal Center
Lakewood, Colorado 80215

February 2, 1996

Dear Mr. Guzy:

The Natural Gas Supply Association, which represents integrated and independent companies that produce and market domestic natural gas, is pleased to offer comments in response to your Federal Register Notice of Proposed Rule issued November 6, 1995, on royalty valuation. This Proposed Rule resulted from a process of negotiated rulemaking initiated by your agency, and is further explained by the consensus document: "Final Report - Federal Gas Valuation Negotiated Rulemaking Committee" ("Reg/Neg Committee").

NGSA strongly endorses the innovative administrative practices of negotiated rulemaking in this proceeding. NGSA believes that this cooperative government-industry effort sets a positive precedent for the resolution of future issues where negotiated rulemaking may be appropriate. The perseverance of industry and government participants, and the positive results of their efforts, demonstrate that accords can be reached on difficult issues. In this instance, the Proposed Rule, while not perfect, provides a greater degree of predictability, flexibility, and clarity that will ease administrative burdens on the federal government lessor and corporate lessees.

Of particular importance to NGSA is that any final rule resulting from this process provide lessees' with the option to select either an index-based or a gross-proceeds-based method for making payments. Using gross proceeds has long been held to be an acceptable method for royalty payment, and therefore needs no further discussion. Use of index pricing is an equally valid valuation method, frequently used in the gas industry for valuation. A study recently completed by the Association, and appended to this document, demonstrates the validity of allowing gas to be valued on an index basis as both an appropriate measure of

valuing gas, and one which assures continued federal government revenue streams, equivalent to those monies generated under a gross proceeds approach. We have attached NGSA's study for your review and for the record.

The same study also contains evidence that the "safety-net" procedures designed to ensure revenue neutrality may not be necessary. It may reasonably be inferred from the study, based on historical data that abandoning the "safety net" would result in greater simplicity, certainty, and administrative savings, without any apparent loss in revenue. Thus, while NGSA does not oppose continued inclusion of the "safety-net" procedures in the final rule, we recommend that MMS re-evaluate their costs and benefits of these procedures, because the appended study suggests that if index pricing had been used for valuation over the past few years, no significant changes to federal government revenue would have occurred.

Should the final rule continue to contain the "safety-net" procedures, we strongly support publication of the "safety-net" calculation within the two years prescribed in the proposed rule. We urge an addition to the rule specifying that, should publication of the calculation not occur in the specified two years, producers' indexed-based payments would be deemed to fulfill royalty obligations. Producers should not be exposed for years and years to the risk of potential back royalty payments simply because the government has failed to provide information which producers need to correct any royalty under-payments.

While NGSA supports the option to use gross-proceeds-based payments, we do not support the definition of gross proceeds contained in the proposal. The value of gas at or near the lease should not include all revenues received by a company or its affiliate. Certain revenue may be received as compensation for services rendered as part of a sales transaction. These fees for services should not be arbitrarily deemed to be payment for the commodity produced. The definition of gross proceeds contained in the proposal was not the result of Committee consensus. The MMS is apparently attempting to state herein its current interpretation of the gross proceeds definition in §206.151. This interpretation has been the subject of much litigation, and is contested by many in the industry. There was not Committee consensus on including the definition now included by the MMS. NGSA therefore opposes its inclusion in the final rule.

NGSA advocates that the definition of gross proceeds include only monies the producer receives for the sale of production. We advocate that this definition be changed because downstream sales often include value for services that have nothing to do with the value of gas. To include compensation for services as part of the royalty-bearing value of gas sold would place producer-marketers at a competitive disadvantage to non-affiliated marketers such as pipeline-marketers, LDC-marketers and independent stand alone marketing companies in the

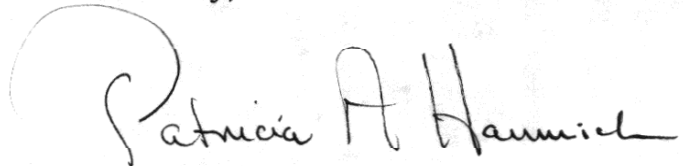
downstream service business. This is not, we believe, the intention of any party to the rulemaking. The proposed definition also works against the federal government's effort (as expressed in FERC Rules) to promote a more robust and competitive market for natural gas. It pressures gas producers to withdraw from competing in the service business, and to confine their activities to sales at the wellhead. If producers cannot recover costs of providing downstream services, they will have no incentive to participate in the service market. Burdened by a higher cost structure than pipeline marketers, or other marketers, producers will not be able to afford extending the same discounts provided by these competitors. If they are not competitive in the downstream service market, producers will be forced to retreat to the wellhead market.

The proposed rule represents a delicate, negotiated consensus among representatives with widely disparate interests. It contains many compromises. NGSA's support of the rule rests on the maintenance of the negotiated balance struck by the Reg/Neg Committee. As a consequence, NGSA endorses the recommendation of the Reg/Neg Committee that, "should the MMS receive substantive comments on the proposed rule during the public comment period that would warrant major changes to the committee recommendations before final rulemaking, the Committee recommends that it be reconvened to resolve any proposed changes." Because MMS, prior to eliciting comments, inserted a definition of "gross proceeds" that was not recommended in the Reg/Neg Committee Report, NGSA believes it should not be adopted in the final rule.

NGSA is committed to staying active in any necessary reconvening of the Reg/Neg Committee. We also plan to participate in any technical conferences and procedures aimed at determining the final zone boundaries and acceptable index publications.

The producer members of NGSA thank you for the opportunity to participate in this precedent-setting negotiation on royalty valuation. We look forward to working with MMS and the Department on future issues relating to the production of natural gas on federal lands.

Sincerely,

A handwritten signature in dark ink, reading "Patricia A. Hammick". The signature is fluid and cursive, with a large loop at the beginning and a long, sweeping tail.

Patricia A. Hammick, Ph. D.
Vice President

Enclosure